No. 83-1228

IN THE

Supreme Court of the United States

October Term, 1983

LEWIS SCALA,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Questions Presented

1. Whether negligent conduct can form the basis for an action by the Securities and Exchange Commission for injunctive relief for violation of the registration provisions of the Securities Act of 1933 (§5(a) thereof).

2. Whether a consent decree, entered into without admitting or denying the allegations, may be used as evidence of prior wrongful conduct so as to determine, for purposes of granting permanent injunctive relief, that there is evidence of a likelihood of recurrence of wrongful conduct.

3. Whether an injunction against violation of the federal securities laws can be granted where the only fact showing the likelihood of future wrongdoing is that the defendant is engaged in business as a stockbroker.

4. Whether, where the conduct at issue is negligent and/or reckless, but not intentionally wrongful, the grant of a permanent injunction in favor of the Securities and Exchange Commission constitutes punishment rather than a deterrant and, accordingly, is improper.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner Lewis Scala hereby petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

Opinions Below

The opinion of the United States District Court for the Southern District of New York in this case is unofficially reported at [1982-83 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,076 (S.D.N.Y. 1983). The opinion of the Court of Appeals is not reported. Both opinions are set forth in the appendix hereto.

Jurisdiction

The judgment of the Court of Appeals was entered on October 27, 1983. This petition for writ of certiorari was filed within ninety (90) days after such date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Statutory Provisions Involved

The pertinent provisions of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. §77a *et seq.*, and the Securities Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C. §78a *et seq.*, are set forth in the Appendix.

Statement of the Case

This petition seeks review of several provisions of the 1933 and 1934 Acts with respect to the ability of the Securities and Exchange Commission (the "Commission") to obtain permanent injunctive relief for violations of the registration and anti-fraud provisions of those statutes, where those violations did not result from an intent to deceive, manipulate or defraud. A permanent injunction was entered by the District Court and affirmed by the Court of Appeals, based upon the conclusion of the Courts below that there was a likelihood that Petitioner, because of his employment in the securities industry as a stockbroker, was, unless enjoined, likely to repeat the violations, even though such violations were not the result of any intentional wrongdoing. It is respectfully submitted that the decisions below resolved issues of law not previously deter-

mined by this Court and did so in a manner inconsistent with the reasoning underlying prior decisions of this Court.

In essence, the wrongful conduct at issue in the Courts below involved the purchase by Petitioner, and the sale to the public, of some 20,500 shares of unregistered stock of World Gambling Corporation ("WGC") from a person found by the Court to have been a nominee of members of a control group of WGC, although such fact was never known to Petitioner. This conduct was found by the District Court to be a violation of §5(a) of the 1933 Act. In addition, the District Court found a violation of §17(a) of the 1933 Act and §10(b) of the 1934 Act resulting from Petitioner's recommendation of WGC stock to one customer, where Petitioner did not verify the accuracy of statements made to him by the principals of WGC and where those statements turned out to have been false.[1] Based on these violations, which the District Court found to have been negligent (with respect to the registration violations) and/or reckless (with respect to the anti-fraud violations), a permanent injunction was entered against Petitioner from any future violations of the federal securities laws.

Petitioner is a stockbroker employed by Norbay Securities, Inc. ("Norbay"), a stock brokerage firm engaged in business as a broker for "penny stocks". The allegations

1. The Commission argued below that Petitioner's entire sales efforts, which involved sales of WGC stock to some 13 public customers over a period of six months, was improper due to the failure of Petitioner to verify the accuracy of information provided to him by WGC. However, the opinion of the District Court referred to only one such customer (App. 11a) and the findings of the District Court made reference to no specific customers. Accordingly, it is apparent that the District Court, after hearing the testimony, only found wrongful conduct with respect to the one customer.

against Petitioner were essentially that he was an unknowing and unwilling participant in a scheme of WGC's principals to distribute unregistered WGC stock to the public and that he violated the anti-fraud provisions of the 1933 Act and 1934 Act by repeating to his customers the information concerning WGC and its prospects given to him by the principals of WGC as part of their overall fraudulent scheme. These principals, John W. Surgent, Jr. and Mark A. Sroka, were, as noted by the District Court in its decision, "the main culprits in a scheme to sell unregistered securities of WGC on fraudulent representations" (App. 9a). These individuals caused more than 100,000 shares of unregistered WGC stock to be distributed to the public by various stock brokerage firms.[2]

Petitioner, after having learned of WGC from one of his customers, and having become interested in the prospects of the company based on what he had been told by Surgent, approached Surgent to inquire if he knew of anyone who might be interested in selling WGC stock. Surgent suggested that David Traxler, who he described as a member of the former management of WGC and as the last former WGC insider who would be in a position to sell his stock, might be interested in disposing of that stock. Based upon information about Traxler provided by Surgent in what was understood by Petitioner to be a three-way conversation with Surgent and, on the other line, Traxler, a new account was opened for Traxler and Petitioner purchased 500 shares from Traxler in August, 1979. After this trans-

2. The other brokerage firms which, in the aggregate, accounted for a considerably greater volume of sales of unregistered WGC stock than did Petitioner and Norbay, were each substantial, well-known brokerage firms and were not, for reasons never explained in the record, named by the Commission as defendants.

action, someone who identified himself as Mr. Traxler came to Petitioner's office at Norbay and picked up a check for the amount of the transaction.

Approximately one month later, Surgent advised Petitioner that Mr. Traxler had an additional 20,000 shares available for sale. In a conversation with Surgent, who advised Petitioner that Mr. Traxler was on the other line, the price for the purchase of the 20,000 shares was negotiated. After the price was agreed upon, and after the stock certificate representing the 20,000 shares was received by Norbay, Petitioner caused a call to be placed to WGC's independent transfer agent in order to verify, as he had been told by Surgent, that there were no restrictions on the tradeability of the WGC stock.[3] Mr. Traxler thereupon came to Norbay's offices to pick up the check for the purchase price of the 20,000 shares.

Unbeknownst to Petitioner, Traxler was acting as a pawn of Messrs. Surgent and Sroka in their plan to sell unregistered shares of WGC stock.[4] Thus, Traxler did not actually own the shares but, instead, was given the shares by Surgent and/or Sroka solely for the purpose of selling them to Norbay, as well as the other stock brokerage firms which purchased 50,000 additional shares from Mr. Traxler. Petitioner did not undertake to do a detailed investigation of Traxler's background, because, under the circumstances then known to him, including the fact that other brokerage

3. The physical stock certificate was also inspected so as to determine that no restrictive legend appeared on its face.

4. A major issue litigated in the Courts below was whether the Commission had proved, by competent evidence, that Traxler was Surgent's nominee. Petitioner does not seek review of the evidentiary rulings made below.

firms were actively trading WGC stock, he did not think it necessary. And, of course, given the existence of the fradulent scheme, it was, at best, highly unlikely that any such investigation as would have been reasonable under the circumstances would have led to discovery of Mr. Traxler's role as nominee.

The Courts below found that Petitioner's efforts to verify that the shares were freely tradeable—by checking with the transfer agent as well as examining the physical certificate—were insufficient and constituted negligent conduct by him, resulting in a finding of a violation of Section 5 of the 1933 Act.

The Commission also alleged below that Petitioner made materially misleading statements concerning the prospects of WGC to his customers when he recommended the purchase of WGC stock to them. In fact, all that Petitioner advised his customers was that, as he had been told by Surgent and Sroka and by written materials disseminated by them, WGC was endeavoring to put together certain transactions and that, if all the proposed deals went through, WGC could do very well in the future but that, on the other hand, if those transactions did not go through, WGC had little profit potential.

Although, at trial, there were five investor witnesses who testified,[5] the District Court only found that one such investor (Albert Markson) was the recipient of misleading

5. Ten of Petitioner's thirteen public customers who purchased WGC stock proffered affidavits, each of which stated that Petitioner had made no exaggerated claims or predictions concerning WGC's prospects and that Petitioner had made them aware that WGC was a speculative investment.

statements. As to that one customer, the testimony at trial was clear that all he had been told was that, *if* WGC "found the right vehicles" it "had a good potential", although Markson was aware that WGC was "speculative". However, inasmuch as the District Court also found that, before this conversation with Mr. Markson, Petitioner should have known that there was no actual factual basis for optimism about WGC, the District Court determined that Petitioner's comments to this customer were inappropriate (App. 10a). Based upon the meeting with WGC's principals, the Court concluded, Petitioner was no longer in a position, if he ever was in such a position, to rely on WGC's principals' assurances as to their plans for the future.[6]

The District Court granted a permanent injunction against Petitioner from future violations of the registered provisions or anti-fraud provisions of the 1933 and 1934 Acts. In reaching this result, obviously, the primary issue facing the Court below was whether there was evidence of a likelihood that Petitioner would repeat the violations. In support of the conclusion that there was such evidence, the Court referred to the fact that Petitioner had, in 1972, been found to have violated the federal securities laws. This finding of a prior violation was "evidenced" by a consent decree entered into with respect to a Commission administrative proceeding alleging net capital violations by the brokerage firm of which Petitioner was then the principal. What the Courts below did not mention, was the fact that that consent decree was entered into *without ad-*

6. In fact, these plans were a total fiction and WGC had no operations or proposed operations worth noting. The record was clear that this fact was not known to Petitioner. Indeed, the Commission itself was only able to determine that WGC was a shell after a lengthy private investigation.

mitting or denying the allegations, and was solely for purposes of settling that administrative proceeding. Finally, the Court below deemed it highly important to the conclusion of the likelihood of recurrence that Petitioner was engaged in business as a stockbroker so that, it reasoned, an injunction was necessary to prevent a repeat of the wrongful conduct.

Reasons for Granting the Writ

POINT I

In determining that proof of negligence alone is a sufficient predicate for injunctive relief for violation of §5 of the 1933 Act, the decision below was inconsistent with the reasoning of prior decisions of this Court.

The Court of Appeals' decision held that, in an injunctive action by the Commission for violation of the registration provisions of the 1933 Act, only a showing of negligence is required, citing its prior decision in *SEC* v. *Universal Major Industries Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977). However, the decision by the Second Circuit in *Universal Major* preceded this Court's decision in *SEC* v. *Aaron*, 446 U.S. 680 (1980), and was expressly premised on those Second Circuit cases which had, prior to *Aaron*, held that, in Commission actions for injunctive relief based upon violation of Section 10(b) of the 1934 Act, a showing of negligence sufficed and that proof of scienter was not required. While, prior to *Aaron*, that may have been the applicable law, the premise is no longer valid in light of *Aaron's* holding that scienter is a necessary element in such a Commission injunction action.

Accordingly, it was incumbent upon the Court below to re-analyze the question of whether scienter is a necessary element in an injunction action for violation of Section 5 of the 1933 Act. Had such analysis been made, Petitioner submits that the reasoning of this Court would have caused the Court below to reach a different result.

SEC v. *Aaron*, of course, dealt with the question of whether a showing of scienter was required in Commission injunctive actions under the anti-fraud provisions of the 1933 and 1934 Acts. Accordingly, the decision in *SEC* v. *Aaron* of this Court is not directly dispositive of the issue presented by this writ; however, it is submitted that this Court's analysis in *Aaron* and in its predecessor case, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), require the conclusion, not reached by the Court below, that a showing of scienter is required to establish a violation of Section 5. This Court has never determined this precise issue and it would appear that, other than the *Universal Major* decision and the decision below, there are no reported decisions directly on point.

In *Hochfelder*, this Court, in the context of a private action for violation of Section 10(b) of the 1934 Act, held that a showing of scienter is required, based upon its analysis of the statutory language. The Court noted that the use in the statute of words such as "to use or employ" suggests volitional conduct must be shown in order to state a claim for a violation. 425 U.S. at 199 n.20.

The Court went on to state

> "We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery

> for negligent conduct, see §§11, 12(2), 15, 15 U.S.C. §§77(k), 77(l)(2), 77(o), is subject to significant procedural restrictions. . . ."

425 U.S. at 208-209. Significantly, in the Court's listing of those provisions of the 1933 Act allowing recovery for negligent conduct, Section 12(1), which is the statutory basis for liability for the sale of unregistered securities, was not mentioned. Thereafter, in the *Aaron* case, this Court recognized that the statutory language governed irrespective of the identity of the plaintiff or the nature of the relief sought.

The statutory language involved in the violation at issue here does not provide any conclusive guidance. Thus, Section 12(1) merely refers to a violation of Section 5 as being the wrongful conduct. Section 5, in turn, states that, unless a registration statement is in effect, it is unlawful to "make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such securities. . . ." However, Section 4 of the 1933 Act must also be considered inasmuch as it specifies certain exemptions to the registration requirement of Section 5. As a result, Sections 4 and 5 have to be read together for either to be fully meaningful. The exemptive provisions of Section 4 do suggest that intentional conduct must be present with respect to the applicability of such exemptions. Thus, Section 4(1) exempts transactions by persons other than an issuer, underwriter or dealer, and underwriter is defined in Section 2(11) as

> "any person who has purchased from an issuer *with a view to* . . . the distribution of any security, or par-

> ticipates or has a direct or indirect participation in any such undertaking. . . ." (emphasis supplied).

Plainly, words such as "view" and "participation" suggest volitional conduct.[7] Similarly, the broker's transaction exemption, found in Section 4(4), also turns on the knowledge of the broker. *SEC* v. *Arco Industries, Inc.* [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶92,921 (S.D.N.Y. 1971).

Accordingly, if the exemptions from Section 5 turn, as they do, on questions of intent, it is submitted that Section 5 itself must be intentionally violated for the Commission to be able to seek injunctive relief.[8] The Court below, however, did not even attempt to square its decision with the holdings and reasoning of this Court in *Hockfelder* and *Aaron*. And, as discussed in Point III, *infra*, under this Court's prior decisions, the entire notion of enjoining non-volitional conduct is highly suspect.

POINT II

The use by the Court below of a consent decree, entered into without admitting or denying the allegations, as "evidence" of prior wrongdoing by Petitioner was improper and unfair.

The decision whether or not to grant a permanent injunction in favor of the Commission turns, in large part, on

7. Indeed, Petitioner's liability in this action is as a statutory underwriter, or a person who took with a "view" to distribution. Plainly, this notion of a view suggests intentional conduct.

8. It is settled that for secondary liability for a violation of Section 5, a showing of knowledge that the securities are unregistered and are not exempt is required. See *SEC* v. *Dolnick*, 501 F.2d 1279 (7th Cir. 1974); *Ness* v. *SEC*, 414 F.2d 211, 220-21 (9th Cir. 1969).

whether it has been demonstrated that there is a likelihood of a future violation. *Aaron* v. *SEC, supra,* 446 U.S. at 701. One of the factors traditionally used by the Courts in determining whether a likelihood of future wrongdoing has been shown is whether there is evidence that, in the past, the defendant has shown a history of violations of the federal securities laws. *See SEC* v. *Commonwealth Chemical Securities, Inc.,* 574 F.2d 90, 98-100 (2d Cir. 1978). The theory is that a recidivist is more likely to violate the law in the future than is a first-time offender.

In the decision below, the *only* evidence referred to by the Court or otherwise present in the record pertaining to prior violations of the securities laws by Petitioner was a consent decree entered into by him in 1972 in disposing of a Commission administrative proceeding. That consent decree pertained to claimed violations of the net capital rules had nothing whatsoever to do with any alleged violation of the registration or anti-fraud provisions. Most importantly, the consent decree expressly stated that the respondent (Petitioner herein)

> "*solely for the purposes of these proceedings* and *without admitting or denying the allegations* in the order for proceedings, consented to certain findings of violation of provisions of the Act alleged in that order and to the imposition of specified sanctions." (emphasis added).

The use by the Court of the consent decree as evidence of prior wrongdoing was plainly improper and allowing the Commission in the future to refer to such consent decrees as evidence of wrongdoing will result in deterring persons under investigation by the Commission from settling those

disputes because of the potentially wide reaching and largely unknowable collateral consequences of the entry into such a consent decree.

This use of a consent decree as proof of the truth of the underlying claims in a subsequent proceeding is contrary to the Federal Rules of Evidence. Indeed, "it has long been established in the Federal Courts that compromises proposed or accepted are not evidence of an admission of the validity or invalidity of the claim or amount of the damage." 2 Weinstein, *Evidence* ¶408[02]. Moreover, the language of Rule 408 of the Federal Rules of Evidence further confirms that the use of an accepted compromise as evidence of the validity of the claim sought to be compromised is improper. Rule 408 is based on the public policy favoring the compromise and settlement of disputes—a policy that would be undermined if the use by the Court below of the consent decree is sustained. *See* Weinstein, *supra*. *See also, Fidelity & Deposit Co. of Maryland* v. *Hudson United Bank*, 493 F. Supp. 434, 445 (D.N.J. 1980). Moreover, a settlement offer or completed settlement, such as the consent decree involved here, implies nothing more than merely a desire for peace and not a confession of wrongful conduct. *See, e.g., Milton S. Kronheim & Co.* v. *United States*, 163 F. Supp. 620, 628 (1958). As a result, using that settlement as evidence, as was done below, is contrary to the motives of a party for entering into such settlement.

Another fundamental reason, ignored by the Court below, for the exclusion of a consent decree as evidence of wrongful conduct is its highly prejudicial effect. A consent

decree is simply a purchase of peace for economic or other reasons. It is

> "in the nature of an uncontested opinion which did not result from adversary presentation of the facts nor from adversary advocacy of the applicable law."

United States v. *Van De Carr*, 343 F. Supp. 993, 1008 (C.D. Cal. 1972). *See also, Purvis* v. *Great Falls Building and Construction Trade Counsel*, 266 F. Supp. 661 (1967). Indeed, this Court, in *United States* v. *International Building Co.*, 345 U.S. 502 (1953), recognized that it was "unable to tell whether the [settlement] agreement of the parties was based on the merits or on some collaterial consideration." 345 U.S. at 505. Here, too, it is impossible to understand what motivated Petitioner in 1972 to enter into the consent decree and, accordingly, it was improper to use such consent decree as the sole evidence of prior wrongdoing.

Moreover, the very purpose of consent decrees in Commission enforcement proceedings would be completely undermined by allowing them to be used as evidence of wrongdoing for purposes of subsequent unrelated proceedings. A major reason for any person to enter into a consent decree in a Commission enforcement proceeding is the desire to end the dispute. However, this motive would be negated were the Commission free to use such consent decree for any colleteral purpose it desired—even as long, as here, as ten years later. Plainly, the Court below's use of the consent decree was incorrect as a matter of the rules of evidence and was unsound as a matter of policy.

POINT III

The Court below ignored the equitable consideration of justice and fairness which are required for the grant of injunctive relief and, instead, used that equitable remedy to impose a penalty.

In *Hecht Co.* v. *Bowles*, 321 U.S. 321 (1944), this Court recognized that a balancing of considerations of fairness and justice is required in any decision to grant permanent injunctive relief. One of the elements of such balancing must be the fact that the entry of a permanent injunction is not a "mild prophylactic"; rather, where as here, the enjoined person is in the securities industry, the entry of a permanent injunction the economic equivalent of the death penalty. This is so because the Commission has the power to suspend Petitioner from the securities business for a substantial period of time, if not permanently, solely by virtue of the fact of the permanent injunction. *See* 1934 Act §15(b)(4)(C). Such suspension would have the effect, on a retail stockbroker such as Petitioner, of severely restricting, if not ending, as a practical matter, his ability to re-enter the business. The decisions below, in granting the entry of a permanent injunction, appear to have totally failed to take this factor into account.

Moreover, any decision to impose a permanent injunction is required to be premised on *positive proof* of some cognizable danger of a recurrence of the violative conduct. *See United States* v. *W.T. Grant Co.*, 345 U.S. 629, 633 (1953). The lower Courts have required that such proof must consist of more than evidence of the underlying violations. Here, however, the only "proof" of a likelihood

of future wrongdoing was found in the fact that Petitioner was still employed as a stockbroker.[9] This is simply insufficient to satisfy the balancing of considerations of fairness and justice required by *Hecht Co.* v. *Bowles*. *See SEC* v. *Arco Industries, Inc., supra; SEC* v. *Caterinicchia*, 613 F.2d 102 (5th Cir. 1980); *SEC* v. *Blatt*, 583 F.2d 325 (5th Cir. 1970); *SEC* v. *Miller*, 495 F. Supp. 465 (S.D.N.Y. 1980). In the cited cases, the defendant was employed in a position identical to that in which he was employed at the time of the wrongful conduct. Nevertheless, the courts in those cases implicitly recognized that the mere fact of employment in a position in which, in theory, future wrongful conduct could occur is not enough upon which to predicate the drastic remedy of a permanent injunction. This is especially pertinent here, where, despite a ten year history of employment in the brokerage field, there is no evidence of any prior violations of the anti-fraud or registration provisions by Petitioner.

Finally, the Court below, in granting an order of permanent injunction based upon inadvertent conduct, in effect impermissably changed the purpose of the injunction from deterrence to punishment.[10] *See SEC* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973). By definition, "negligence is

9. As noted in Point II, the Court of Appeals' decision also used the fact of the consent decree as evidence of likely future wrongdoing.

10. The Commission's apparent use of its authority to obtain injunctive relief as *punishment* is further highlighted by its unexplained failure to take any action against the other brokerage firms that sold WGC stock purportedly owned by Mr. Traxler to the public. Also reflective of the desire to punish Petitioner is the fact that the District Court, at the Commission's urging, rejected Petitioner's proffer of a stipulation to the effect that Petitioner would not violate the securities laws in the future. This rejection was undoubtedly motivated by the Commission's desire to use an injunction as a means of barring Petitioner from the securities industry.

inadvertent and unintended." *SEC* v. *Geotek*, 426 F. Supp. 715 (N.D. Cal. 1976). In recognition of this fact, this Court in *Aaron*, noted that the *degree* of intentional conduct was a very important factor to be taken into account in determining whether to impose injunctive relief. 466 U.S. 680. Indeed, Chief Justice Burger, in his concurring opinion in *Aaron*, noted that the issue raised in *Aaron* of whether a showing of scienter is necessary

> "may be much ado about nothing. This is so because of the requirement in injunctive proceedings of a showing that 'there is a reasonable likelihood that the wrong will be repeated.' [citations omitted]. To make such a showing, it will almost always be necessary for the Commission to demonstrate that the defendant's past sins have been the result of more than negligence. Because the Commission must show some likelihood of a future violation, defendants whose past actions have been in good faith are not likely to be enjoined. See opinion of the Court, *Ante*, at 701. That is as it should be. An injunction is a drastic remedy, not a mild prophylactic, and should not be obtained against one acting in good faith."

446 U.S. 703 (Burger, C.J. concurring).

The decisions below, in entering a permanent injunction against Petitioner, did violence to these precepts. Plainly, negligent conduct is unintended and accidental and is entirely foreign to the preventative concept underlying the entry of an injunction. Accordingly, it can only be concluded that the injunction was intended by the Courts below as a means of punishment, and, as such, it was plainly improper.

By enjoining Petitioner for negligent or careless conduct, the decision below has held that a stockbroker is essentially an insurer that all that he has been told is accurate. This result goes beyond any of the cases (see *Smith* v. *Christie*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,828 (N.D. Cal. 1980)) and, Petitioner submits, imposes a duty that is unreasonable in the actual market place.

POINT IV

Reckless conduct should not be allowed to be the equivalent of scienter.

In its decision in *Hochfelder*, this Court defined scienter as referring to "a mental state embracing intent to deceive, manipulate or defraud" and specifically declined to address the question of whether recklessness is sufficient to be the functional equivalent of scienter. 425 U.S. at 194 n.12. Recklessness has been variously defined by the Courts. *Compare Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 133, 145 (7th Cir.), *cert. denied* 434 U.S. 875 (1977), *with Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1306 n.98 (2d Cir. 1973) (*en banc*). At the minimum, however recklessness is defined, it is premised on non-intentional misleading statements.[11] For all the reasons set forth in Point III, *supra*, recklessness should not be the functional equivalent of scienter and the question left open in *Hochfelder* should be decided.

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11. And, in the context of this case, where all that Petitioner did was to suggest tentative conclusions to his customers about possible future plans of the company without checking on the likelihood of those plans coming to fruition, the conduct does not, Petitioner submits, come within either definition of recklessness.

Conclusion

The petition for a writ of certiorari should be granted and the judgment below should be reversed.

Dated: New York, New York
January 24, 1984

Respectfully submitted,

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APPENDIX

Order of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 27th day of October one thousand nine hundred and eighty-three.

PRESENT:

HON. RICHARD J. CARDAMONE
HON. LAWRENCE W. PIERCE
HON. GEORGE C. PRATT
Circuit Judges.

83-6102

SECURITIES AND EXCHANGE COMMISSION,
Appellee,

v.

WORLD GAMBLING CORPORATION, *et al.*,
Defendants,

and

LEWIS SCALA,
Defendant-Appellant,

Appeal from the United States District Court for the Southern District of New York.

Appellant Scala appeals from a judgment entered on March 4, 1983, in the United States District Court for the Southern District of New York, Abraham B. Sofaer, *Judge*, granting the motion of the Securities and Exchange Commission (SEC) for a permanent injunction and order to disgorge profits upon a finding that appellant violated the registration provisions of the Securities Act of 1933, 15 U.S.C. §§ 77e(a) and 77e(c) (Section 5) and the anti-fraud provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (Section 10(b)).

On appeal, appellant contends that he was erroneously found liable for violations of the registration and anti-fraud provisions of the federal securities laws and that the remedies of permanent injunction and disgorgement were inappropriate.

1. *Registration Violations*

Under Section 5 of the Securities Act of 1933, 15 U.S.C. §§ 77e(a) and 77e(c), it is unlawful for any person, directly or indirectly, to sell or offer to buy or sell an unregistered security. It is undisputed that shares of the World Gambling Corporation (WGC) were not registered at the time they were sold by Scala to public investors. Appellant contends, however, that his purchase of the stock from David Traxler brings his transactions within the exemptions of Section 4(1) of the 1933 Act, 15 U.S.C. § 77d(1) (person other than issuer, underwriter or dealer). We find that there was ample evidence adduced at trial—through Scala's own testimony that he never dealt directly with Traxler but rather with John Surgent, a principal officer of WGC, as well as the properly admitted investigatory deposition of

Traxler, Fed. R. Evid. 804(a)(4) (witness unavailable because of death); Fed. R. Evid. 804(b)(3) (statement against interest), who admitted that he had agreed to act as a nominee for Surgent—to show that Traxler was part of WGC's control group and that the transactions were therefore not exempt under Section 4(1). *See* 15 U.S.C. § 77b(11); *U.S. v. Wolfson*, 405 F.2d 779, 782 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969).

There was also evidence that Scala was at the very least negligent in failing to determine that the WGC stock was not registered. He improperly relied on "the self-serving statements of his sellers . . . without reasonably exploring the possibility of contrary facts." *SEC v. Culpepper*, 270 F.2d 241, 251 (2d Cir. 1959). Scala's lack of familiarity with Traxler indicated that further investigation of WGC was appropriate, *see Babcock*, 44 S.E.C. 350, 353 (1970), and his call to the transfer agent after he had already sold shares of stock came too late, *see id.* We reject appellant's contention that the failure to determine that the stock was not registered should be judged under the scienter standard of *Aaron v. SEC*, 446 U.S. 680 (1980). Unlike a Section 10(b) violation, violation of the registration provision of Section 5 does not involve the kind of intentional conduct which would suggest a scienter requirement. *See id.* at 696. The applicable law is set forth in *SEC v. Universal Major Industries Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977), which held that an SEC injunctive action for violation of Section 5 only requires a showing of negligence. We therefore conclude that Scala's negligent failure to discover that the WGC stock was unregistered violates Section 5 of the 1933 Act.

2. *Anti-fraud Violations*

The SEC must prove scienter with respect to Scala's anti-fraud violations, *Aaron* v. *SEC*, 446 U.S. 680 (1980), and proof of reckless conduct meets the requirement of scienter in a 10(b) claim, *Sirota* v. *Solitron Devices, Inc.*, 673 F.2d 566, 575 (2d Cir.), *cert. denied*, 103 S. Ct. 86 (1982). We agree with the findings of the district court that Scala's conduct with respect to the sale of WGC stock to his customers was clearly reckless. In our view Scala, after initiating contact with WGC and serving as the principal trader of that stock, had an obligation as a salesman for Norbay to provide his employer, as a market maker in the stock, with the necessary information for a "due diligence" file on WGC in compliance with 17 C.F.R. 240.15c2-11 (1983). After receiving information regarding WGC giving him reason to doubt the corporation's financial well-being and eventually reaching his own conclusion that "something was not right," Scala continued to recommend the purchase of stock to his customers. Since the danger to investors was either known to Scala, or so obvious that he must have been aware of it, we find that his conduct was a reckless departure from the standard of ordinary care. *See Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1038 (1978).

3. *Appropriateness of Relief*

We find the grant of injunctive relief sought by the SEC appropriate based on (1) our conclusion that there exists herein a clear basis for a finding of scienter; (2) a previous securities law violation which resulted in a consent judg-

ment and revocation of Scala's broker-dealer registration, *see In re Lewis Scala*, Securities Exchange Act Release No. 9768 (September 14, 1972); and (3) the fact that Scala's professional occupation raises the possibility of future violations. *SEC v. Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 100 (2d Cir. 1978). Disgorgement serves the valid purpose "of forcing [Scala] to give up the amount by which he was unjustly enriched," *id.* at 102. We conclude that the district court did not abuse its discretion by granting a permanent injunction and ordering disgorgement. *See SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100 (2d Cir. 1972).

The judgment of the district court is therefore affirmed.

/s/ RICHARD J. CARDAMONE

Honorable Richard J. Cardamone,

/s/ LAWRENCE W. PIERCE

Honorable Lawrence W. Pierce,

/s/ GEORGE C. PRATT

Honorable George C. Pratt,
Circuit Judges.

Memorandum Opinion and Order of United States District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

82 Civ. 3821 (ADS)

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

against

WORLD GAMBLING CORPORATION; SURGENT, JOHN W. JR.; SROKA, MARK A.; POOLE, HARRY; HAMLEY, JAMES J.; NORBAY SECURITIES INC.; SCALA, LEWIS; FEINTUCH, BERNARD,

Defendants.

APPEARANCES:

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—Attorneys for Defendant Mark Sroka—

ABRAHAM D. SOFAER, D.J.:

This is an action by the SEC to obtain injunctions against six defendants prohibiting them from violating the registration and antifraud provisions of the federal securities laws. 15 U.S.C. §§ 77e(a), (c), 77q(a), 78j (1976). Preliminary injunctions issued after a hearing against three of the defendants, World Gambling Corp. ("WGC"), and its two principal officers, John W. Surgent and Mark A. Sroka. The three were thereafter ordered to show cause why these injunctions should not be made permanent. These defendants were the main culprits in a scheme to sell unregistered securities of WGC on fraudulent representations, and the Court preliminarily found on the record that the conduct and background of these defendants makes it likely that they may engage, or with respect to WGC that it may be used, in further illegal conduct of the types enjoined.

Pursuant to the Court's order, the defendant Surgent appeared and sought a further opportunity to contest his liability, as well as to oppose the SEC's request for an order of disgorgement. He failed to appear at the hearing sched-

uled at his request, however, and therefore has defaulted. In any event, the SEC established in its able brief on this issue that Surgent would have been precluded from contesting liability by the doctrine of collateral estoppel, given the evidence introduced against him at his criminal trial. Sroka also appeared pursuant to the order to show cause, but he sought to contest only the amount for which he ought to be ordered to disgorge, claiming that he received only about $5,000 of the sums obtained in the scheme. Therefore, on the basis of the findings made on the record, and in the orders issued herewith, and given the concessions and/or defaults of WGC, Surgent, and Sroka, the injunctions against them are hereby made permanent. In addition, for the reasons given in the findings entered against Surgent and Sroka, and the stipulations in the record, the orders of disgorgement sought concerning those individuals are wholly justified. The evidence shows that Sroka was a knowing partner with Surgent in the crimes they committed, and that he pleaded guilty to transactions involving proceeds of $13,000. His participation in the crimes was extensive, and necessary to the scheme's success, and therefore justifies his being held jointly and severally liable for the full amount of the profits obtained, or $68,486.90 *see* Pl. Ex. 200, though not for the amount obtained independently by Surgent in looting the subsidiary of WGC known as AEI. *See, SEC* v. *R.J. Allen & Assoc., Inc.*, 386 F. Supp. 866, 880-81 (S.D. Fla. 1974); *Ross* v. *Licht*, 263 F. Supp. 395, 410-11 (S.D.N.Y. 1967).

Sroka properly argues that disgorgement serves somewhat different purposes from those served by joint-tortfeasor liability. While disgorgement functions primarily

to prevent a party's unjust enrichment and thereby to deter improper conduct, joint liability serves primarily to make whole the injured party, and in the process to punish if necessary any one legally responsible. To the extent that joint liability requires payment of a sum greater than the profits unlawfully gained by the fraudulent transactions, it is a penalty and is therefore improper. *See SEC* v. *Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *SEC* v. *Manor Nursing Centers*, 458 F.2d 1082, 1104 (2d Cir. 1972). These principles are of no assistance to Sroka in this case, however. Had Sroka proved that he obtained only a certain amount from the scheme, then he could conceivably have argued convincingly that, despite his extensive participation in the conspiracy, he should not be required to disgorge what he did not receive. But he failed to prove that he received any specific amount, or even that he received less than a given amount. Consequently, the SEC should not be prevented from collecting the amount obtained in the scheme from either or both Surgent and Sroka. The two culprits would be free of course to sue one another for contribution if one claims that he was required to pay what the other received.

Bernard Feintuch, a former registered representative with the defendant, Norbay Securities, has consented to a permanent injunction, as has Harry Poole. In addition, the SEC has obtained a default against the defendant James J. Hamley. The SEC now seeks to enjoin permanently Norbay Securities and its trader/registered representative Lewis Scala to prevent their violating the registration and antifraud provisions in the future, as well as an order that they disgorge their profits. The relevant parties have stipulated

that the present record, made on motion for a preliminary injunction, will be considered complete for purposes of deciding whether a permanent injunction should issue, and have reached stipulations on the profits obtained. On the basis of the following findings and conclusions, a permanent injunction will issue with respect to Scala but not with respect to Norbay. Norbay and Scala will, however, be required to disgorge all profits made on their transactions of WGC stock to the extent described below, and will remain subject to this Court's jurisdiction by reason of their stipulations on the record to refrain from violating the laws and regulations described in the SEC's proposed orders of permanent injunction.

The facts relating to the scheme to defraud perpetrated by Surgent and Sroka are set out in the preliminary injunctions issued against them. Findings of Fact Nos. 1-53 are hereby adopted for present purposes, from the order respecting Surgent. On the basis of those findings it is clear that Scala and Norbay sold unregistered WGC stock, and that they sent their clients false information regarding that stock. In addition, the evidence showed that Scala should have become suspicious when he arranged with Surgent for the sale of WGC stock to Norbay in an account in the name of Traxler, a third person with whom Scala did not deal. Scala later opened another account at the request of Surgent in the name of James Marshall, a real estate broker who testified that no one from Norbay ever contacted him concerning the account. Furthermore, while Scala called the transfer agent regarding WGC stock, he did so only after having already sold some of the shares, and in the present circumstances that measure was insufficient to con-

stitute proper care. *See Babcock & Co.*, 44 S.E.C. 350 (1970). Scala failed to carry out his responsibility for checking out the financial facts of WGC and maintaining a proper file for Norbay, which was a market maker in WGC stock. *See* 17 C.F.R. 240.15c2-11 (1982). He also communicated to his customers all the false information he received about WGC, and he told his customers, including Albert Markson, without any adequate basis, that WGC had a promising future and competent management. Finally, he bought and sold WGC stock through a nominee account, making a profit while his customers lost money.

Applying the factors approved in *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 100 (2d Cir. 1978) to Scala, there is a reasonable likelihood that he would commit future violations of the registration and antifraud provisions of the federal securities laws. Scala's conduct may not have been wilful, but it was clearly reckless. He should have checked further into Surgent's relationship with Traxler, among other things. Furthermore, with respect to his own purchases and sales he knowingly favored himself over his customers. After his visit to WGC in early 1980, when he found Surgent "evasive," he should have taken remedial action; instead, he thereafter sold to Markson WGC stock on the representation that WGC was well managed, and continued to sell stock to other customers. Although Scala engaged in this conduct only with respect to WGC stock, his activities extended over a period of months, involved several customers, and violated at least three fundamental legal obligations that Scala had specifically undertaken in behalf of Norbay: (1) to take reasonable steps to insure that the stock was registered; (2) to check on the accuracy of WGC

representations before passing them on to customers; and (3) to maintain a due-diligence file to justify Norbay's role as market-maker.

Scala is willing to assure the Court that he will abide by the relevant laws, and has offered to sign a stipulation to that effect. He has not admitted, however, that his conduct was deficient, and his present position at Norbay gives him the capacity to violate the law again. The proposed stipulation that Scala is willing to enter into is in any event not a proper substitute for an injunction. The SEC cannot be deprived of the relief it seeks by a device that essentially grants that relief but substitutes judicial enforcement for SEC enforcement. Here, given the nature and degree of Scala's violations, an injunction is proper.

Applying the same factors to Norbay Securities, a permanent injunction is not an appropriate remedy. Norbay it is true is responsible for the conduct of its employees and is derivatively liable for violating the laws involved. But even though a finding of scienter may not be a prerequisite for injunctive relief, it is a relevant consideration when such a harsh equitable remedy is being sought. The evidence failed to establish that Norbay's owner and controlling officer, Benjamin Taormina, knew anything about WGC that should have led him to be suspicious as to its registered status or as to the statements issued concerning its finances or activities. Taormina trusted his principal trader, Scala, to satisfy all the obligations at issue in this case, and no proof was offered to demonstrate that he knew or should have known of Scala's failure to satisfy these obligations. The Court accepts Taormina's testimony that he believed Scala had checked out WGC and was maintaining a due-diligence file on the company. Not only was the testimony

credible, but Norbay's prior business record supplied it with significant support; Norbay has done many underwritings, has sold many securities as a market maker, and, according to Taormina's uncontradicted claim, had never before sold unregistered stock or acted as a market maker without first obtaining proper information. Taormina was not grossly reckless, as the SEC claims, in trusting Scala, since Scala has worked complaint-free at Norbay for several years, and was well aware of his obligations.

Many defects have existed in Norbay's operation, and some may well continue to exist, including inadequate compliance supervision. Those defects have been corrected in most respects, however, especially insofar as they relate to the statutory violations sought to be enjoined. Furthermore, while the SEC established that Norbay's supervision was deficient in general, those deficiencies had no causal relationship to Scala's conduct. Scala well appreciated his obligations and, as a principal trader, was himself a person who had supervisory authority. While for Scala the incident was significant, for Norbay the WGC stock was only one of many issues handled by its traders, and the only one on which Norbay found itself in violation of the registration and antifraud provisions. Other violations by Norbay are not insignificant, and although they have been considered, they do not indicate that Norbay will intentionally engage in the conduct to be enjoined. Moreover, new procedures undertaken by Norbay make it highly unlikely that these violations will occur again by accident. Based on the lack of similar instances, and the credibility of Mr. Taormina, Norbay is unlikely to engage further in the conduct actually sought to be enjoined.

No weight has been given in reaching these findings and conclusions to the fact that Norbay and Benjamin Taormina offered to stipulate that they will not engage in any of the acts sought by the SEC to be enjoined. Nevertheless, the stipulation is accepted as additional corroboration for the Court's view, and as a deterrent against any such conduct, since it authorizes use of the contempt power or any other proper remedy to punish the signatories for violating the stipulation.

The SEC repeatedly emphasized at trial that Norbay is engaged in selling "penny" stocks, or highly speculative securities. The clear suggestion implicit in the government's case is that the public would be better off without such an operation. Yet, the SEC failed to prove that the public is any less inclined to gamble on stocks than on horses or the lottery; indeed the record shows that those lawful options present far greater risks than investing in stocks at Norbay. Taormina, Scala, and several customers testified without contradiction that everyone dealing in "penny" stocks at Norbay is told and knows that these stocks are highly speculative; nevertheless, Taormina said without contradiction that WGC is the only stock Norbay has either underwritten or for which it has made a market, that has been a total loss. While other "penny" stock operations may be illegitimate, the evidence shows, as Norbay's counsel artfully put it, that his clients are not "telephonic thugs."

Perhaps the SEC's desire to obtain permanent injunctions against Norbay and Scala led it to overlook the far more appropriate sanction of disgorgement. After the Court suggested the possible propriety of disgorgement, however, the SEC agreed that disgorgement would be

proper, and has since established a legal and evidentiary basis for such orders. The parties have stipulated that Norbay made a total profit, less the cost of the stock and transfer taxes, of $29,000 from its sales of WGC stock, and that the total profit was divided as follows: $11,700 to Norbay, $11,700 to Scala, and $5,600 to Feintuch.

Norbay's attorney argues that disgorgement has been reserved for egregious cases, and as a method for deterring improper activity; he contends that Norbay's violations were not egregious, and that no deterrent purpose could be served by ordering disgorgement, since Norbay did not act wilfully. No convincing proof has been advanced, however, that the SEC seeks disgorgement only for egregious conduct. The SEC, spurred on primarily by Second Circuit decisions, appears, in fact, to have "moved decisively to utilize" ancillary remedies, including disgorgement, since the 1960s, to remedy a variety of violations. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 Harv. L. Rev. 1779, 1800 (1976); *see, e.g., SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972). Counsel for Norbay concedes, in fact, that disgorgement is a less onerous remedy, at least in this case, than an injunction, and the SEC failed initially to seek it only on the premise that an injunction would be obtained.

In any event, however limited the SEC's prior use of disgorgement, it is a remedy that gives courts flexibility to adjust the punishment for securities violations to fit the wrongful conduct and to accomplish Congress' objectives. While Norbay's owner was not shown to have acted intentionally, his principal trader and one other employee both knowingly violated the law. Disgorgement of Norbay's profit under these circumstances will serve both general and

specific deterrant purposes by signalling principals of securities firms that they will not be permitted to profit from securities violations at their customers' expense, and by encouraging Norbay's owner in particular to exercise greater care. Furthermore, while disgorgement has been said to serve more important interests than the compensation of investors, *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 102 (2d Cir. 1978), that principle is a far cry from the proposition that restitution is an improper end. Compensatory awards are "uniquely suited to redress or concel unfairness and promote investor confidence in securities transactions." Farrand, *supra*, 89 Harv. L. Rev. at 1803. And the need for disgorgement is especially keen in this case, since the small amounts lost by individual investors make the Act's private remedies less effective than in cases where substantial monetary incentives encourage such actions. Norbay must repay the profit it made, even if the only purpose served thereby were to restore funds improperly obtained from its customers.

Under the circumstances of this case, however, Norbay should not be required to disgorge any more than the profit it made, i.e. $11,700.00. Both Scala and Feintuch are the more responsible parties, having been shown to have made misrepresentations, so the circumstances do not warrant holding Norbay financially responsible for their activity. On the other hand, neither do the circumstances warrant reducing this amount by Norbay's overhead costs or by a hypothetical corporate income tax rate. Norbay's only true overhead costs would be the marginal costs of handling these specific transactiosn—an amount much lower than its average cost per transaction. Norbay's true taxes on the profit are not even known, since there is no indication

of what taxes were in fact paid, what impact would have resulted in taxes if these transactions were eliminated, or what rights Norbay has to offset its loss caused by disgorgement in future tax years. Even if these computations were appropriate, they are not worth making in this case, given the small amount at issue. The "profit obtained" cannot be said to be a punitive standard for disgorgement, even though it may be slightly overstated by overhead and income taxes, and in any event that standard remains the proper measure for achieving restitution, which is itself a proper objective.

The case for requiring Scala to disgorge is in some respects stronger than for requiring Norbay to do so, since he committed some intentionally wrongful acts. On the other hand, the deterrent objectives in punishing Scala are adequately vindicated by the injunction to be issued against him, and a disgorgement of his actual profit, or $11,700. Scala's conduct was seriously deficient, but his behavior was not as egregiously fradulent as that of Surgent or Sroka; to an extent, he too was a victim of the scheme. To require Scala or Norbay to pay also the profits obtained by Feintuch would constitute a fine, not disgorgement, since Feintuch clearly obtained and retained those funds. *See SEC* v. *Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *SEC* v. *Manor Nursing Centers*, 458 F.2d 1082, 1104 (2d Cir. 1972). In any event, the order would be unwarranted under the circumstances of this case.

In conclusion, the injunctions and disgorgement sought by the SEC against WGC, Surgent, and Sroka, are granted. An injunction will also issue against Scala, but he will be required to disgorge only $11,700. An injunction will not issue against Norbay, but it too will be required to disgorge

its profits of $11,700. All payments will be made to the SEC in the manner provided in the applicable judgments, and the SEC will disburse the funds collected in a manner designed fairly to compensate the victims of these frauds. All other issues having been resolved, this case will be closed upon the entry of the judgments signed this date, and judgments concerning Norbay and Scala that incorporate the findings and rulings contained in this opinion.

So Ordered.

Dated: New York, New York
January 31, 1982

/s/ Abraham D. Sofaer

Abraham D. Sofaer
U.S. District Judge

Final Judgment of Permanent Injunction and Order of Disgorgement Against Defendant Lewis Scala

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

82 Civ. 3821 (ADS)

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

against

WORLD GAMBLING CORPORATION
JOHN W. SURGENT, JR.
MARK A. SROKA
HARRY POOLE
JAMES J. HAMLEY
NORBAY SECURITIES, INC.
LEWIS SCALA
BERNARD FEINTUCH

Defendants.

Plaintiff Securities and Exchange Commission ("Commission"), having commenced this action by filing its Complaint on June 10, 1982 seeking to enjoin defendant Lewis Scala ("Scala") and others from violating Sections 5(a),

5(c) and 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §77e(a), 77e(c) and 77q(a), and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78j(b), and Rule 10b-5 promulgated thereunder, 17 U.S.C. §240.10b-5, defendant Scala having filed his answer on August 20, 1982, and plaintiff Commission having moved this Court for an Order of Preliminary Injunction against defendant Scala on September 17, 1982, and a hearing on such motion having been held on November 9 through 11, 1982, and such hearing having been consolidated with a trial on the merits pursuant to Rule 65(b) of the Federal Rules of Civil Procedure; and this Court having issued a Memorandum Opinion and Order on January 31, 1983 containing Findings of Fact and Conclusions of law pursuant to Rule 52 of the Federal Rules of Civil Procedure incorporating the following Findings of Fact:

Defendant Surgent

1. Defendant John W. Surgent ("Surgent") has been President and a director of World Gambling Corporation ("WGC") since on or about July 16, 1979. Surgent currently resides at 1035 Wildwood Court, Lake Ariel, Pennsylvania.

2. Surgent was a defendant in a prior civil injunctive action brought by the Commission, *SEC* v. *Iannelli*, 74 Civ. 3417 (S.D.N.Y.). On February 19, 1975, following a trial before Judge Constance Baker Motley, Surgent was permanently enjoined from further violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. The Court found that Surgent had aided and abetted violations of the afore-

said provisions in connection with a manipulation of the market in the common stock of Omni RX Health Systems, Inc.

3. On May 11, 1976 pursuant to Rule 2(e) of the Commission's Rules of Practice, 17 C.F.R. §201.2(e), the Commission issued an Order suspending Surgent from practicing before the Commission for a period of five (5) years commencing April 1, 1975. The Order provided that at the end of said period, Surgent would be automatically reinstated in the absence of: 1) other and further alleged violations of the Federal securities laws; 2) professional disciplinary proceedings resulting in the imposition of some penalty or sanction; and 3) any criminal convictions involving moral turpitude. *In the Matter of John W. Surgent, Esquire,* Admin. Pro. File No. 3-4666. 9 SEC Dkt. 620 (1976). As a consequence of a sanction imposed on Surgent by the New Jersey Supreme Court, the Commission, in a letter, advised Surgent on or about May 1, 1980 that the 2(e) Order was being continued and that Surgent would have to apply for readmission to practice before the Commission in accordance with Rule 2(e)(4)(ii).

4. On May 14, 1979, Surgent was suspended from the practice of law for six months, beginning May 28, 1979, by the New Jersey Supreme Court for violations of the State Code of Ethics. *John Surgent, Attorney at Law,* 79 N.J. 529 (1979). Surgent was indicted by a New Jersey Grand Jury on February 7, 1980 for obtaining money from a bank under false pretenses, *State of New Jersey* v. *Surgent,* No. I-86-79-J (Super. Ct. N.J. 1980).

5. On November 4, 1981, defendants Surgent and Mark A. Sroka ("Sroka") were indicted by a federal grand jury sitting in the Southern District of New York. The indictment charged Surgent and Sroka with many of the same transactions, acts, practices and courses of business alleged in the Commission's Complaint in this action. On March 19, 1982, following a trial by jury, Surgent was convicted on all fourteen counts: one count of conspiracy, 18 U.S.C. §371, three counts of securities fraud, 15 U.S.C. §§78j(b) and 78ff and 18 U.S.C. §2, one count of wire fraud, 18 U.S.C. §§1343 and 2, one count of subornation of perjury, 18 U.S.C. §§1622 and 2, six counts of the sale of unregistered securities, 15 U.S.C. §§77e and 77x and 18 U.S.C. §2, and two counts of mail fraud, 18 U.S.C. §§1341 and 2. On June 9, 1982, Surgent was sentenced by Judge Thomas Griesa to ten years in prison. Surgent's prison sentence has been stayed pending appeal.

Background

6. WGC was incorporated in the State of New York in 1937 under the name of Simplified Records Publishing Company, Inc. In 1943, the corporate name was changed to Simplified Tax Records, Inc. In 1963, the name of the company was again changed to Simplified Business Services, Inc. ("SBS"). The company's business involved bookkeeping, data processing and tax preparation for small corporations. On October 29, 1968, SBS filed a registration statement with the Commission. Pursuant to the registration, effective April 15, 1969, SBS publicly offered 110,000 units, each unit consisting of one share of common stock and two warrants to purchase such stock.

7. On or about December 2, 1970, SBS filed a Petition for Arrangement, pursuant to Chapter XI, Section 322 of the Bankruptcy Act. Approximately five years later, on September 25, 1975, the Petition for Arrangement was dismissed.

8. On September 23, 1971, a controlling interest in SBS was purchased by Special Situations, Inc. ("Special Situations"), a small privately-held investment company located in Bala Cynwyd, Pennsylvania. Special Situations was operated by Martin Miller ("Miller") and owned by Miller, Alan Moskowitz and several other individuals, with Miller and Moskowitz being the majority shareholders. Special Situations acquired 600,000 shares of SBS stock. Herbert Maxwell ("Maxwell"), who acted as a "finder" in bringing SBS and Special Situations together, received 100,000 of the SBS shares, which were placed in his wife's name. As of June 25, 1979, the total number of SBS shares outstanding was 1,046,850, owned by approximately 475 shareholders. This total included a limited number of shares which had previously been issued to the company's prior officers.

9. Between 1975 and May 1979, when the subject violations commenced, SBS had minimal assets and minimal business operations. The stock was listed periodically in the pink sheets throughout this period, although there was little activity in the issue.

10. In the spring of 1979, defendant Surgent, in Sroka's presence, asked defendant Harry Poole ("Poole") to locate a "shell" company. On or about May 17, 1979, Poole read and answered an advertisement, placed by Miller, in the Wall Street Journal, offering an over-the-counter ("OTC")

company for sale. When Poole responded to the advertisement, Miller told Poole that he had a company called SBS available for sale. Subsequently, a meeting was arranged with Poole, Miller, Surgent, Sroka and Miller's son Jonathon. Negotiations ensued, and another meeting was held in Miller's office in Bala Cynwyd on June 22, 1979.

11. At the meeting on June 22, 1979, Surgent entered into an agreement ("Agreement") with SBS and Special Situations. Miller, as a majority shareholder of Special Situations, agreed, *inter alia*, that Jonathon Miller, acting as Special Situation's proxy, would vote that entity's shares at the next SBS shareholders meeting in favor of: a) a name change of the company from SBS to WGC; b) a reverse three-for-one split of the outstanding shares of WGC common stock; c) the issuance by WGC of 2,143,550 post-split shares of WGC common stock in the name of Surgent, thereby making Surgent the record owner of approximately eighty-six percent (86%) of the outstanding shares of the company; and d) the transfer of the bookkeeping and tax preparation business of WGC to Special Situations. Pursuant to the Agreement, Surgent was obligated to pay $100,000 to WGC on or before October 10, 1979, in exchange for the 2,143,550 shares that would be issued to him. Such sum of money has never been paid to WGC. Poole was to receive 100,000 post-split shares of WGC stock from Special Situations as his finder's fee, pursuant to a separate agreement.

12. A Notice of a Special Meeting of SBS Shareholders, dated June 22, 1979, was prepared and mailed on or before July 2, 1979. The Notice advised shareholders that a meeting would be held at 100 Presidential Blvd., Bala Cynwyd, Pennsylvania on July 16, 1979 for the purpose of, among

other things: 1) acting upon a proposal to adopt the Agreement; 2) the election of a new slate of officers and directors; and 3) the ratification of a proposed sale of the company's assets to Special Situations for $40,525. The Notice also disclosed that there would be no solicitation of proxies and that Special Situations, SBS' controlling shareholder, would vote its shares in favor of the proposals listed. Attached to the Notice was an "Information Statement" which described the terms of the Agreement.

13. On July 16, 1979, the shareholders meeting was held in Miller's office. Maxwell, Miller and Miller's son, Jonathon, were the only SBS shareholders present. Jonathon Miller voted Special Situations' shares in favor of the proposals. In addition, Surgent was elected the new President and a director, and Sroka was made Secretary and a director, of WGC. Miller, who also acted as the transfer agent for SBS, issued 2,068,550 unregistered and legended WGC shares (post-split) to Surgent. The additional 75,000 shares that Surgent was to receive were issued to Poole for the reasons set forth in Paragraph 15, below. WGC's offices were subsequently moved to 62 Mount Prospect Avenue, Clifton, New Jersey, and the reverse three-to-one split was effected.

Accumulation of Stock in the Name of Defendants Surgent and Sroka's Nominee

14. In June and July of 1979, Surgent and Sroka caused 95.000 WGC shares to be placed in the name of their nominee, David Traxler ("Traxler"). These 95,000 shares were accumulated from various sources as discussed below

(All references to amounts of shares will hereinafter reflect the reverse 3-for-1 stock split.)

15. Miller, on behalf of Special Situations, had agreed to pay Poole 100,000 WGC shares for Poole's services as a finder on June 14, 1979. However, at the request of Surgent and in Sroka's presence, Poole agreed to have 75,000 of the shares he was to receive from Special Situations placed in Traxler's name. In return for this agreement, Surgent agreed to have 75,000 of the WGC shares that he was entitled to receive upon acquiring the company issued to Poole. These transactions occurred on July 16, 1979.

16. On or about June 20, 1979, Poole, who was then employed as a registered representative at Selheimer & Co. ("Selheimer"), told Surgent that he had purchased 1,667 shares of WGC stock for his own account. Surgent told Poole that he wanted this stock to be placed in Traxler's name. Poole called Selheimer and had an account opened in Traxler's name utilizing information supplied by Sroka. Poole then had the purchase of the 1,667 shares credited to the Traxler account. This purchase was executed at Selheimer on June 20, 1979 at a cost of $1850.00. On or about June 29, 1979, Poole met with Surgent and Sroka and received from Sroka a pre-signed check drawn on David Traxler's checking account at National Community Bank. Sroka had previously supplied Traxler's account at the bank with the funds to cover this check. Sroka filled out the amount of the check and the name of the payee (Selheimer) and gave the check to Poole to pay for the June 20th purchase.

17. On or about July 16, 1979, Miller told Surgent, Sroka and Poole that Maxwell owned a block of WGC stock. This was stock acquired by Maxwell when Special Situations acquired SBS. A few days later, Poole, on behalf of Surgent and Sroka, contacted Maxwell and offered to buy his stock. Maxwell had sold a portion of his stock in June and July 1979, but still owned some shares. He agreed to sell 18,333 shares for $5,000. Maxwell received a check in the mail for $5,000 drawn on the account of Doncaster Group Corp. ("Doncaster"), one of the businesses controlled by Surgent and Sroka; the check was returned due to uncollected funds. On or about August 8, 1979, Surgent hand-delivered another check to Maxwell in Sroka's presence. This check was also drawn on the account of Doncaster. The shares purchased from Maxwell were subsequently placed in Traxler's name.

Distribution of WGC Stock

18. Of the 95,000 shares of restricted WGC stock accumulated by Surgent and Sroka, 74,834 shares were offered and sold through four broker-dealers, including Norbay Securities Inc. ("Norbay"), by Traxler (acting as Surgent and Sroka's nominee), 4,333 restricted shares were offered and sold directly to public investors by Surgent and Sroka, and 10,000 shares were pledged and hypothecated to Citizen's First National Bank of New Jersey as collateral for a loan by defendant Hamley at Surgent's direction. Hamley also sold 5,000 WGC shares at a brokerage firm at Surgent and Sroka's direction. No registration statement was filed or in effect with the Commission as to any of these transactions.

19. From on or about June 25, 1979, to on or about January 15, 1980, 94,167 shares of WGC restricted stock were sold or pledged at Surgent and Sroka's direction and for their benefit. Surgent and Sroka had acquired the 95,000 WGC restricted shares and subsequently sold or pledged all but 833 shares for a total of $81,408.87.

Sales Through Selheimer

20. On July 27, 1979, Perry Selheimer, a partner of Selheimer, received a telephone call from someone who identified himself as David Traxler. The person on the telephone asked for the current price of WGC stock, and during the conversation entered an order to sell the 1,667 shares that had previously been purchased in the David Traxler account. The order was executed, with the net proceeds of the sale totalling $4,700. During this same telephone call, the caller also asked to have Selheimer sell for him 10,000 more shares of WGC. Perry Selheimer refused to execute the proposed trade. On August 3, 1979, the settlement date for the July 27th trade, Poole told Perry Selheimer that he would be meeting Traxler in Philadelphia and asked if he could hand deliver the check for the proceeds of the sale. Selheimer agreed and gave Poole the check.

21. Poole brought the check which Selheimer had given him to a previously arranged meeting at Miller's office in Bala Cynwyd, Pennsylvania, at which Sroka, Surgent, Miller and Traxler were present. Surgent told Poole to accompany Traxler to a branch of the bank on which the check was drawn, and Traxler had the check cashed. Poole and Traxler returned to Miller's office and Traxler handed

the entire proceeds of the check to Surgent. Later the same day, on the train returning to New Jersey, Sroka gave Traxler $150 in cash.

Sales Through Norbay

22. On or about July 1979, Scala was contacted by one of his clients at Norbay. The client was a previous holder of SBS stock and had received the June 22, 1979 Notice of Special Meeting of Shareholders. The client told Scala about SBS's proposed name change to WGC and wanted to know the price at which the stock was trading. Scala said the new name, WGC, sounded exciting and asked the customer to send him the information which he had received about the company. The customer sent Scala the June 22nd Notice. Scala, upon reading the Notice, decided to contact the company. He called Martin Miller, who referred him to John Surgent.

23. Scala called Surgent, who was identified in the June 22, 1979 Notice as the person who would become WGC's president after the acquisition, and informed him that he was a stockbroker and wanted to know something about the company. Surgent told Scala the company was getting involved in Atlantic City and generally spoke very positively about the company.

24. In the following months, Scala maintained close contact with Surgent and Sroka through frequent telephone conversations. These calls were alternatively initiated by Scala and by Sroka or Surgent. Generally, during these calls, Surgent discussed with Scala various plans for WGC; Sroka usually called to get a quote on the price of WGC

stock. During one of the conversations between Scala and Surgent, Scala indicated he had some clients who might be interested in purchasing WGC stock.

25. On or about August 21, 1979, Scala called Surgent and asked him if he knew of anyone who wanted to sell some WGC stock. Scala wanted to buy five hundred shares in order to cover his short position in the stock. Surgent told Scala that he knew a man named David Traxler, whom Surgent identified as a principal of the old company, SBS. Surgent also told Scala that Traxler had an additional 20,000 shares remaining which he wanted to sell. Surgent indicated to Scala that Traxler would be willing to sell the five hundred shares for $3.50 per share. Scala agreed to these terms and, utilizing information supplied by Surgent, filled out a new account card for Traxler. The account card, which was initialed by an officer of Norbay, stated that Traxler was referred to the firm by "John Surgent (World Gambling Corp)". Scala then executed the sale of the five hundred shares at $3.50 per share in the Traxler account to Norbay's trading account. A certificate for 500 shares of WGC stock was subsequently delivered to Norbay. On August 28, 1979, the settlement date for the August 21st trade, a check in the amount of $1,746.88, representing the proceeds of the sale, was picked up at Norbay by an individual purporting to be David Traxler. On or about August 28, 1979, Sroka visited Traxler at St. Mary's hospital where Traxler had been confined since on or about August 6, 1979 due to respiratory problems. Sroka asked Traxler to endorse the Norbay check for $1,746.88 because Sroka needed money. Traxler endorsed the check and gave Sroka a handwritten note directed to Ruth Eckert ("Eckert"), the as-

sistant cashier at Traxler's bank. The note requested that Eckert cash this check for Traxler and give the proceeds to Sroka. Sroka took the note and the check to the bank and presented them to Eckert who then cashed the check and gave the proceeds to Sroka.

26. In a subsequent telephone conversation between Scala and Surgent, Surgent again mentioned that Traxler still had 20,000 shares of WGC stock that he was willing to sell. Scala told Surgent that he would not pay the "market price" for the shares, which at that time was approximately $1.25, but was willing to pay substantially less. Surgent and Scala negotiated a price of $.875 per share for the 20,000 shares. The trade was executed on September 28, 1979 by Scala, who sold the 20,000 shares for Traxler's account to Norbay's firm trading account.

27. Scala accepted the 20,000 share block of WGC stock from Surgent without obtaining from Traxler proof of purchase or opinion of counsel regarding the transferability of the shares. The only step purportedly taken by Norbay to ascertain the transferability of this block was to telephone the transfer agent to see if the stock was legended. The Taominas were not shown personally to have known any facts that should have led them to be suspicious, and they relied on Scala to check on WGC.

28. The proceeds from the sale of the 20,000 WGC shares through Traxler's account were $17,375. On October 5, 1979, the settlement date for the trade, Traxler, at Surgent and Sroka's direction, went to the cashier at Norbay to pick up the check for $17,375. Traxler testified during

the Commission's investigation that this was his first and only visit to Norbay, that this sale of the 20,000 shares was the only transaction at Norbay that he was aware of, and that he only became aware of the transaction after receiving the confirmation of sale in the mail. Scala never met Traxler at any time during the period in which the above-described transactions in Traxler's Norbay account occurred.

29. After presenting identification, Traxler received the check from Norbay's cashier and took it to a branch of the bank on which the check was drawn to be cashed. The bank refused to cash the check due to the large amount. Traxler then called Surgent and Sroka at the offices of WGC and told them he was having difficulty cashing the check. They told Traxler they would call Scala. Traxler waited and subsequently was called back at the bank and participated in a conference call between Surgent, Sroka and Scala. During this conversation, Surgent and Sroka asked Scala why Traxler could not cash the check. Surgent also accused Scala of wanting to play with "his [Surgent's] money." After some delay the bank agreed to certify the check and Traxler took it to his own bank in Rutherford, New Jersey, where the check was ultimately cashed. Traxler then took the money to WGC's offices where Surgent and Sroka were waiting for him and personally handed Surgent the entire proceeds of the check. Surgent gave Traxler $1,600 from the $17,375, purportedly in repayment of a prior debt.

30. A majority of the 20,000 shares of WGC stock acquired by Norbay from Traxler was subsequently sold to Norbay customers in September 1979 and October 1979.

Sales Through Shearson

31. On or about September 27, 1979, an account was opened in Traxler's name at the brokerage firm of Shearson, Loeb, Rhoades, Inc. ("Shearson") in Bloomfield, New Jersey. (The account was originally opened at the firm of Loeb, Rhoades, Hornblower, Inc., which shortly thereafter merged with Shearson.) Traxler's registered representative at Shearson was James T. Hamlisch ("Hamlisch"). Traxler told Hamlisch that he wanted to sell 10,000 shares of WGC stock, and subsequently delivered the stock to Shearson. The sale was executed on September 27, 1979, at the price of $1.03 per share. On October 4, 1979, the settlement date for the September 27th sale, Shearson issued Traxler a check in the amount of $9,458.31, which was picked up by Debra Plecs ("Plecs"), Surgent's secretary at WGC. Surgent had directed Plecs to go to Shearson and represent herself as Traxler's secretary, and to use the name Barbara Anderson to avoid association with Surgent. After Plecs received the check, she drove Traxler to Morgan Guaranty Bank in Manhattan, where, at Surgent's direction, Traxler cashed the check. Traxler later gave the proceeds of the check to Surgent and Sroka.

32. On October 16, 1979, Traxler delivered 7,667 shares of WGC stock to Hamlisch at the Shearson office and told Hamlisch that he wanted to sell the shares. The shares were sold on that day for $5,508.06. On the settlement date, October 23rd, Plecs picked up the check for the proceeds of the sale, again representing herself as Traxler's secretary, and drove Traxler to Manhattan to cash the check, all at Surgent and Sroka's direction. Once more, Traxler subse-

quently gave the proceeds of the check to Surgent and Sroka.

33. On two additional occasions, Traxler delivered stock to Shearson and placed sell orders. On October 18, 1979, Traxler delivered 5,000 shares and on November 27, 1979, he delivered 20,000 shares. The 5,000 shares were sold in two trades on October 18, 1979: 500 shares were sold at $1.00 per share and 4,500 shares were sold at $.75 per share. The proceeds of these two sales totalled $3,601.54. On the settlement date for the October 18th sale, Plecs, acting under the direction of Surgent, picked up the check for the proceeds of the sale and drove Traxler to the Morgan Guaranty Bank, where he cashed the check. He later turned the proceeds over to Surgent and Sroka. The sale of the 20,000 shares which Traxler delivered to Shearson on November 27, 1979 was broken up into four trades occurring on November 27, November 30 and December 5, 1979. One check was issued to Traxler on December 7, 1979 in the amount of $5,769.10 for the proceeds of the November 27 and November 30, 1979 trades. This check was also picked up by Plecs who then drove Traxler to the Chemical Bank at 305 Seventh Avenue in Manhattan, where the check was cashed. On December 12, 1979, Shearson issued a check to Traxler in the amount of $1,895.10 for the proceeds of the December 5, 1979 sales. On this occasion, Traxler picked up the check from Shearson and cashed it at the National Community Bank of New Jersey. In each instance, Surgent and/or Sroka directed Traxler to enter the sell orders and cash the checks, and in each instance Traxler gave the proceeds of the sales to Surgent and Sroka.

Sales Through Thomson

34. In January 1980, Traxler and Sroka agreed to sell some WGC stock without sharing the proceeds with Surgent. Sroka suggested that Traxler open an account at a different brokerage firm. On or about January 15, 1980, Traxler opened an account in the Saddlebrook, New Jersey office of Thomson McKinnon Securities, Inc. On January 15, 1980, 10,000 shares of WGC stock were sold from this account at $.75 per share. The proceeds of this sale amounted to $6,921.88. Traxler deposited the check reflecting the proceeds into his personal checking account at National Community Bank. After the check cleared, he gave Sroka a check for $3,000.

Sale and Pledge by Hamley

35. On or about January 14, 1980, defendant Hamley, at Surgent's direction, opened an account at the brokerage firm of Paine, Webber, Jackson and Curtis, Inc. ("Paine Webber"), in Iselin, New Jersey. At Surgent's direction, Hamley entered an order to sell 5,000 shares of WGC stock. Hamley delivered to the firm a 5,000 shares of WGC stock in Traxler's name along with a stock power executed by Traxler. This sale was executed on January 14, 1980 at a price of $.75 per share, with proceeds totalling $3,433. Paine Webber issue a check to Hamley for the proceeds of the sale on January 16, 1980. Hamley picked up the check at the Paine Webber office and immediately cashed it at a nearby bank. Hamley then went to WGC's offices and handed over to Surgent the entire proceeds of the check.

36. On January 9, 1980, at Surgent's direction, Hamley applied for and received $10,000 loan from Citizen's First National Bank of New Jersey ("Citizen's Bank"), using 10,000 WGC shares of Traxler stock as collateral. Citizen's Bank transferred the stock into Hamley's name and credited Hamley's account $10,000. Hamley then wrote out a check for $8,000 drawn to the order of cash which he gave to Surgent, and kept the remaining $2,000. The loan has not been repaid.

Sales to Individuals by Surgent and Sroka

37. On or about June 25, 1979, Surgent sold 1,000 shares of WGC restricted stock that was in Traxler's name to Stephen Freiman ("Freiman"). Freiman is a businessman and acquaintance of Sroka and Surgent who rented office space in the complex where WGC had its offices. Freiman payed $1,000 for the WGC shares. Surgent told Freiman to make the check for the purchase payable to Doncaster, an entity controlled by Surgent and Sroka. The transactions took place at WGC's offices and Freiman gave the check directly to Surgent.

38. On or about August 3, 1979, Poole, on behalf of Surgent, asked Miller to buy 3,333 shares of WGC stock from Traxler for $10,000. Miller made out a check for $10,000, payable to Traxler, and gave the check to Surgent.

Misrepresentations and Omissions of Material Facts by WGC, Surgent and Sroka

39. Throughout the violative period, WGC itself had no corporate assets other than its ownership of its subsid-

iaries, AEI Corp ("AEI"), Gresco Corp. and Gresco Export ("Gresco"), all of which were in need of large infusions of capital to avoid bankruptcy. Surgent and Sroka nevertheless gave investors the impression that WGC was a company with an exciting and profitable future. They did so by issuing newsletters, by making oral statements which were false and misleading and by failing to disclose significant negative corporate events to shareholders and prospective shareholders of WGC.

40. WGC, Surgent and Sroka omitted to inform prospective and actual WGC investors of the following material corporate events:

A. *Corporate Dissolution*

41. On December 15, 1975 the Secretary of State of New York dissolved WGC pursuant to Section 203-a of the New York Tax Law for tax delinquency over a three-year period. Sroka was advised of WGC's dissolution by a letter dated July 11, 1979 from the Secretary of State's office, but failed to pay the back taxes. After that date, WGC continued to engage in normal business activity as if the corporate charter was still in effect. WGC's dissolution was never disclosed to WGC shareholders.

B. *Surgent's Purported Contribution of Capital*

42. As part of the Agreement to purchase SBS, Surgent agreed to invest $100,000 into the company. This promise was included in the June 22, 1979 Notice of a Special Shareholders Meeting which was sent to shareholders and brokers.

Annexed to the Notice was an Agreement of Sale which stated that the $100,000 would consist of $25,000 in cash and a $75,000 collaterized note payable October 10, 1979. Surgent did not place $25,000 into a company account, as promised, and never transferred collateral to WGC to secure the $75,000 note. These facts were never disclosed to WGC shareholders.

C. *Omissions Relating to AEI*

43. Defendants Surgent and Sroka, on behalf of WGC and AEI, executed an agreement promising to pay Smith, AEI's former owner, her husband and four former AEI shareholders an amount totalling $112,400. The notes were to be paid in monthly installments with the first payment due on December 8, 1979. None of these notes were paid. WGC shareholders and brokers were not informed that the notes were not paid.

44. In addition to defendant WGC, Surgent and Sroka's failure to disclose that they did not pay for AEI, they failed to disclose several other material matters concerning AEI. First, during December of 1979 and January 1980, Surgent signed at least fourteen checks, drawn on the AEI payroll and regular checking accounts, which were paid to himself and others who had no relationship to AEI. For instance, Surgent issued a check to Peter Wolfe, the owner of a burglar alarm business named United Securities Service in Luzerne, Pennsylvania. The check, dated January 10, 1980, and drawn to the amount of $1,854.00, was in payment for an alarm system Surgent had installed at his home. In addition, Surgent ordered two Mercedes-Benz automobiles,

one to be placed in Surgent's wife's name and the other to be placed in Hamley's name. Surgent used AEI checks to pay a $1,000 deposit, $2,104.98 for sales tax and $7,118 upon delivery of one of the cars. Neither Hamley nor Penelope Surgent, Surgent's wife, were employees of AEI.

45. The AEI checks signed by Surgent and paid to Surgent and other individuals having no relationship to AEI totalled $34,892.28, an amount which constituted almost 50% of the AEI's total deposits for December 1979 and January 1980.

46. In addition, WGC shareholders were never informed that from at least November 21, 1979 to mid-January, 1980, AEI employees' paychecks and checks to AEI contractors were not honored due to insufficient or uncollected funds in the AEI account, that the AEI account had a $15,121 deficit from on or about March 6, 1980 until December 31, 1980, when the account was closed, and that the company's telephone had been disconnected in late January 1980. Investors were also never told that AEI was not current in its accounts payable and that the company was forced into involuntary bankruptcy on or about February 22, 1980. Finally, on several occasions, Surgent deposited checks into AEI's checking account with full knowledge that the accounts on which the checks were drawn did not have sufficient funds to cover the checks.

False and Misleading Shareholder Releases and Misrepresentations by Surgent

47. Two false and misleading newsletters, dated November 9, 1979 and November 30, 1979, dictated by Surgent to

his secretary and issued under Sroka's name with Sroka's knowledge, were mailed to approximately four hundred WGC shareholders and to selected brokers who were making a market in WGC stock.

(1) *November 9, 1979 Newsletter*

48. The first newsletter, dated November 9, 1979, contained false and misleading statements regarding at least four matters: 1) the development of gambling in Atlantic City, New Jersey; 2) the acquisition of Gresco; 3) negotiations for the acquisition of two restaurants; and 4) projections of WGC's future earnings. First, the newsletter announced that WGC was planning the development of a gambling business in Atlantic City, New Jersey, and had entered preliminary negotiations to acquire property and make financial arrangements. In actuality, WGC did not have the necessary financing or capital available to develop a gambling business, and never acquired or held an option on any land in Atlantic City.

49. Second, the November 9, 1979 newsletter stated that WGC had entered into a Letter of Intent to acquire Gresco, a giftware manufacturing company located in Jersey City, New Jersey, and that sales from Gresco in the upcoming year were expected to be in excess of $1 million. In fact, Gresco had been controlled by Surgent and Sroka since July 1979, when Doncaster (a company controlled by them) had acquired Gresco. Surgent and Sroka transfered the company to WGC in September 1979. A $1 million sales projection had no realistic basis because the company was in severe financial distress. The consolidated income state-

ment for Gresco Corp. and Gresco Export Corp. for the five months ending September 30, 1979 showed sales of only $51,438 and a net loss of $26,230. WGC, Surgent and Sroka never disclosed to WGC's shareholders and market-makers that Gresco's assets were seized by the National Bank of North America in April or May, 1980 for failure to pay an outstanding loan of approximately $95,000.

50. Third, the November 9th, 1979 newsletter stated that WGC had entered into negotiations to acquire The Palace Restaurant and Proof of the Pudding, two well-known Manhattan restaurants. In actuality, there was only one meeting held between Frank Valenza, the owner of the restaurants, and representatives of WGC. After the discussion, at which Valenza talked about his plans for the restaurants, Valenza told the WGC representatives to contact his attorney if they were interested in purchasing the restaurants. Valenza's attorney was never contacted by representatives of WGC and WGC has not acquired either restaurant. The limited nature of the discussions held between Valenza and the WGC representatives and the fact that WGC never acquired the restaurants was not disclosed to WGC shareholders and market-makers.

51. Lastly, the November 9, 1979 newsletter predicted earnings of $1.00 to $1.10 per share on WGC stock if the negotiations regarding the aforementioned deals were finalized. In light of the poor financial condition of WGC and its subsidiaries, AEI and Gresco, neither WGC, Surgent nor Sroka had a factual basis for making such a projection.

(2) *November 30, 1979 Newsletter*

52. The second newsletter, dated November 30, 1979, concerned WGC's acquisition of AEI Corporation ("AEI"). AEI was a contract packaging business located in Bethlehem, Pennsylvania and was owned by Virginia Smith ("Smith"). The newsletter stated, *inter alia*, that WGC had successfully acquired AEI, that Smith would continue to be employed by AEI to head sales and marketing, and that Smith had been asked to prepare and expand a proprietary food line to supply hotels and casinos. The newsletter did not state, however, that: a) AEI had operated at a loss since 1975 and was currently operating with limited working capital; b) as of September 30, 1979, current liabilities exceeded current assets by $71,946; and c) Surgent and Sroka had not paid for AEI, but had signed promissory notes which they subsequently failed to honor.

Misrepresentations by Surgent

53. Surgent also personally solicited investors, telling them that WGC owned land in Atlantic City or owned an option for land there, and that WGC had one million dollars in cash or had 100 million dollars in financing, all of which were false. He also told investors that the price of WGC stock would rise to $15 or $20 per share.

FURTHER, this Court having found that defendant Scala violated Sections 5(a), 5(c) and 17(a) of the Securities Act, 15 U.S.C. §§77e(a), 77e(c) and 77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. §78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5, and having found that there is a reasonable likelihood that defendant

Scala will violate the above-specified provisions of the federal securities laws in the future unless he is enjoined; and that there is no reason for delay, it is hereby:

ORDERED, ADJUDGED AND DECREED that defendant Scala, his agents, servants, employees, attorneys, nominees, assigns, corporations and other entities under his control, and those persons in active concert or participation with him, and each of them, be and hereby are permanently enjoined from, directly or indirectly, in the absence of any applicable statutory exemption:

(1) making use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell securities of WGC or any other securities, through the use or medium of any prospectus or otherwise, unless a registration statement is in effect with plaintiff Commission as to such securities;

(2) carrying or causing to be carried through the mails or in interstate commerce, by any means or instruments of transportation, WGC securities, or any other securities, for the purpose of sale or for delivery after sale, unless a registration statement is in effect with plaintiff Commission as to such securities;

(3) making use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy WGC securities, or any other securities, through the use or medium of any prospectus or otherwise, unless a registration statement has been filed with plaintiff Commission as to such securities; or while

> the registration while the registration [*sic*] statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under Section 8 of the Securities Act, 15 U.S.C. §§77(h);

in violation of Sections 5(a) and 5(c) of the Securities Act, 15 U.S.C. §§77e(a) and 77e(c).

IT IS FURTHER ORDERED that defendant Scala, his agents, servants, employees, attorneys, nominees, assigns, corporations and other entities under his control, and those persons in active concert or participation with him, and each of them, be and hereby are permanently enjoined from, directly or indirectly, singly or in concert, in the offer or sale, or in connection with the purchase or sale, of WGC securities, or any other securities, by the use of any means or instruments of transportation or communication in, or instrumentalities of, interstate commerce or of the mails, or the facilities of any national securities exchange:

(1) employing any device, scheme or artifice to defraud:

(2) obtaining money or property by means of, or otherwise making, any untrue statement of material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, concerning, among other things:

(a) representations about the future prospects of a public corporation, the management of said corporation, or the rise in the price of the com-

mon stock of said corporation, without a reasonable basis for such representations;

(b) recommendations to purchase or sell the common stock of said corporation without a reasonable basis for such representations; or

(c) distributing, either orally or in writing, information received by said corporation without a reasonable basis for believing such information is true and accurate;

(3) engaging in any act, transactions, practice or course of business which operates or would operate as a fraud or deceit upon any person;

in violation of Section 17(a) of the Securities Act, 15 U.S.C. §77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. §78j(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5.

It Is Further Ordered that defendant Scala pay to this Court the sum of $11,700 in full satisfaction of the disgorgement sought by plaintiff representing the amount of profits obtained by Scala from transactions in WGC stock. The foregoing sum ("the principal") shall be paid by Scala within ninety (90) days of the entry of this Judgment and Order, in the following manner:

(a) The principal to be paid by defendant Scala shall be paid into the registry of this Court by certified check drawn to the order of "Clerk, United States District Court, S.D.N.Y."; whereupon the Clerk of this Court, or the financial deputy clerk, is hereby directed to deposit the said check in an interest bearing account, in the name and to

the credit of this Court, in the following designated depository for money of this Court: Manufacturers Hanover Trust Company, Branch #35, 277 Broadway, New York, New York.

(b) Interest earned on the account shall be credited to the acount and shall thereafter be treated in the same manner as the principal.

(c) That the distribution of the amount paid by defendant Scala pursuant to this Judgment and Order, shall be effected according to such plan or terms as will be submitted by plaintiff Commission, subject to the approval of this Court, with cost of administration and distribution, if any, to be paid from the principal plus interest accrued on such sums. In no event shall any sums disgorged or interest accrued thereon be returned to the defendant Scala.

IT IS FURTHER ORDERED that this Order of Disgorgement shall be enforceable by all legal and equitable remedies available to plaintiff Commission, or to any officer, agency or instrumentality of the United States.

IT IS FURTHER ORDERED that personal service of this order be effected upon defendant Scala.

IT IS FURTHER ORDERED that this Court shall retain jurisdiction of this matter for all purposes.

/s/ ABRAHAM D. SOFAER

ABRAHAM D. SOFAER
United States District Judge

Dated: New York, New York
March 2, 1983

JUDGMENT ENTERED: 3/4/83

/s/ RAYMOND F. BURGHARDT

Clerk

A TRUE COPY

/s/ RAYMOND F. BURGHARDT, Clerk

By /s/ ROBERT LAMORTE

Deputy Clerk

Statutes

Sections 2(11) & (12) of the Securities Act of 1933, 15 U.S.C. 77b(11) & (12)

§ 77b. Definitions

When used in this subchapter, unless the context otherwise requires—

* * *

(11) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

(12) The term "dealer" means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.

Sections 4(1) through (4) of the Securities Act of 1933, 15 U.S.C. 77d(1)-(4)

§ 77d. Exempted transactions

The provisions of section 77e of this title shall not apply to—

(1) transactions by any person other than an issuer, underwriter, or dealer.

(2) transactions by an issuer not involving any public offering.

(3) transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except—

(A) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter,

(B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 77h of this title is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order, and

(C) transactions as to securities constituting the whole or a part of an unsold allotment to or subscrip-

tion by such dealer as as participant in the distribution of such securities by the issuer or by or through an underwriter.

With respect to transactions referred to in clause (B), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.

(4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.

Sections 5(a) & (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) & (c)

§ 77e. Prohibitions relating to interstate commerce and the mails

(a) Sale or delivery after sale of unregistered securities

Unless a registration statement is in effect as a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

• • •

(c) Necessity of filing registration statement

It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

Section 12 of the Securities Act of 1933, 15 U.S.C. 77l

§ 77l. Civil liabilities arising in connection with prospectuses and communications

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of

proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a)

77q. Fraudulent interstate transactions

(a) Use of interstate commerce for purpose of fraud or deceit

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

* * *

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b)

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 under the Securities Exchange Act, 17 C.F.R. 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.